BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
AARON T. AND VIOLA P. FELKINS)
WILLIAM L. AND BERTHA M. FELKINS)
WILLIAM W. AND DIXIE C. LEERSKOV)

Appearances:

For Appellant: Archibald M. Mull, Jr., Attorney at Law

For Respondent: F. Edward Caine, Associate Tax Counsel
Wilbur F. Lavelle, Assistant Counsel

O P I N I O N

These appeals are made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax against Aaron T. and Viola P. Felkins in the amounts of $93.55, $1,726.10 and $3,592.30 for the years 1952, 1953 and 1954, respectively, against William L. and Bertha M. Felkins in the amounts of $409.88 and $3,622.66 for the years 1953 and 1954, respectively, and against William W. and Dixie C. Leerskov in the amount of $2,050.89 for the year 1954.

During the three years in question Appellant Aaron T. Felkins either operated a coin machine business as a single proprietor or was a member of a partnership which operated a coin machine business. In 1952, until April 15, he was in partnership with Richard L. Gray under the name of Valley Amusement Co. That partnership was terminated. Appellant Aaron T. Felkins operated for a short time as a single proprietor and on May 1, 1952, formed a new partnership with Ray S. Fuller which existed until March 27, 1953. At the latter date, Mr. Felkins purchased Mr. Fuller's interest and operated as a single proprietor until April 16, 1953, when he entered a partnership with his brother, William L. Felkins, which partnership-operated under the name of Felkins Music Co. On May 1, 1954, Appellant William W. Leerskov was admitted into this

partnership and the partnership continued through the end of 1954. The assessments in question arise out.of the businesses conducted by the partnerships and single proprietorship mentioned, but Richard L. Gray and Ray S. Fuller have not filed appeals to this Eoard from the assessments made by the Franchise Tax Board, Hereafter the word "Appellants" will be used to refer to-the single proprietorship or partnership, as the case may be, which owned and operated the coin machine business from time to time during the years 1952, 1953 and 1954.

Appellants owned pinball machines, music machines, bowling machines, shuffleboards and guns. The machines were placed in restaurants, taverns and other locations under an arrangement with each location owner that Appellants would maintain the machine in proper working order, that the location owner would furnish the electricity to operate the machine, that Appellants would retain the key to the coin box on the machine, and that Appellants would visit the location periodically to open the machine and count and wrap the coins. At the time of each collection the location owner informed Appellants of the amount of the expenses paid by the location owner in connection with the operation of the machine and this amount was set aside for him from the amount in the machine, The balance was divided equally between Appellants and the location owner. The expenses paid by the location owners included cash paid to players of pinball machines for free games not played off, and taxes and licenses assessed against the machines.

appellants had between thirty and forty locations and had one pinball machine in most of the locations. In addition, there were in some locations another kind of machine such as a music machine or shuffleboard. In a few locations Appellants had other types of machines but no pinball machines.

Appellant William L. Felkins was interviewed by Respondent's auditor in 1954, and at the time of the interview stated that all of the pinball machines were of the multiple-odd type. A multiple-odd type of pinball machine is one in which the player deposits one coin to release the balls for play. Before shooting the balls the player may deposit additional coins to advance the odds (that is the number of free games won for a given winning combination). The player is not assured that any given additional coin will advance the odds, This is determined by a mechanism in the machine over which the player has no control.

The customary practice of the location owners who had multiple-odd type pinball machines was to pay cash on request to a player for free games not played off. To facilitate such

payment, the machines were equipped with a removal button which upon being pressed removed the number of free games registered on the machine, Some of the machines had meters which recorded the number of free plays thus removed and frequently Appellants would read the meter in connection with their collection. Most of the time the amount claimed by a location owner for expenses agreed fairly closely with the amount assumed to have been paid to players as recorded on this meter.

The amounts reported by Appellants as gross income from the business for income tax purposes were the amounts retained after the division with the location owners. Deductions were taken for depreciation, cost of phonograph records, and other business expenses.

Respondent recomputed gross income on the theory that all the coins deposited in the machines by players constituted gross income to Appellants. Respondent's position is that Appellants rented space in the locations and that the location owners' 50% share of the net proceeds was a rental payment.

Respondent computed the amounts deposited in the machines by taking Appellants! reported gross income and doubling it to arrive at the net proceeds of all types of machines prior to the division with the location owner. Of this amount Respondent estimated that 80% in the case of the Gray-Felkins partnership and 60% as to all subsequent operations was derived from multiple-odd type pinball machines. This estimate is taken directly from an estimate given by Appellant Aaron T. Felkins when interviewed by Respondent's auditor in 1954, Respondent then concluded that the amount derived from multiple-odd type pinball machines had been reduced by cash payouts to winning players and estimated that the cash payouts equalled 45% of the amounts originally deposited in the machines. The 45% payout percentage estimate was based on estimates given by two location owners interviewed by Respondent's auditor in 1954. One of these location owners estimated payouts at 50% or more and the other at 40%.

Respondent also disallowed all expenses, including cash payouts, rental paid to location owners and the business expenses claimed on returns. Respondent disallowed all expenses because it concluded that Appellants were engaged in an illegal activity and therefore that Section 17359 (now 17297) of the Revenue and Taxation Code was applicable. Section 17359 read:

> In computing net income, no deductions shall be allowed to any taxpayer on any of his gross income

> derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

Section 330a of the Penal Code makes it a crime to possess or control a "mechanical device, upon the result of action of which money,.. is ... hazarded, and which is operated ... by . . . depositing therein any coins . . . and by means whereof . . . money . . . is won or lost ... when the result of action of such machine ... is dependent upon hazard or chance." Section 330a is a part of Chapter 10 of Title 9 of Part 1 of the Penal Code of California.

Respondent contends that the multiple-odd type pinball machines in question are primarily games of chance and that money may be won or lost as a result of action of the machines* Respondent concludes, therefore, that Section 17359 was applicable. It is of the opinion that it made a reasonable estimate of Appellants' gross income and that in accordance with Section 17359 it was proper to disallow all expenses since the expenses were either related to the operation of multiple-odd type pinball machines or related to other types of equipment the operation of which was connected or associated with the operation of multiple-odd. type pinball machines.

In Appeal of C. B. Hall, Sr., Cal. St, Bd. of Equal., Dec. 29, 1958 (2 CCH Cal. Tax Cas,, Par.201-197), (3 P-H State 8 Local Tax Serv,, Cal., Par 58,145), we held that the multiple-odd feature on a pinball machine such as here in question makes the successful operation of the machine dependent primarily upon chance and, therefore, that the operation of the machine violated Section 330a of the Penal Code. Since money was won or lost on the result of action of the machines, the operation of the multiple-odd type pinball machines owned by Appellants violated Section 330a of the Penal Code and Respondent was correct in applying Section 17359.

The operating arrangements between Appellants and each location owner were the same as those considered by us in the Appeal of C.B. Hall, Sr., supra. Our conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of the machines is, accordingly, applicable here. Respondent's assessments, therefore, must be revised to reduce Appellants' gross income from 100% to 50% of

the coins deposited in the machine.

As we also held in Hall, supra, Respondent's computation of gross income is presumptively correct. There *were* no records indicating the amounts paid to winning players for free games not played off, Respondent computed the amount on the best available evidence. Appellant Aaron T. Felkins testified that the amounts claimed for cash payouts by location owners who had multiple-odd type pinball machines averaged 25% to 45% of the amounts in the machines, This testimony, however, is not necessarily in conflict with Respondent's computation of the cash payouts; We think Respondent's method was reasonably accurate and, therefore, except for the reduction due to our conclusion that Appellants and each location owner were engaged in a joint venture, Respondent 's computation of gross income is sustained,

The business operated by Appellants had no employees. The partners performed all the duties. The partners collected and repaired and also solicited new locations. Appellants' business was an integrated one with the various segments each contributing to the success of the entire business, Accordingly, the legal activity of operating music machines and other amusement equipment was connected or associated in a substantial way with the illegal activity of operating multiple-odd type pinball machines and Respondent properly disallowed all expenses of the business.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code that the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax against Aaron T. and Viola P. Felkins in the amounts of $93.55, $1,726.10 and $3,592.30 for the years 1952, 1953 and 1954, respectively, against William L. and Bertha M. Felkins in the amounts of $409.88 and $3,622.66 *for* the years 1953 and 1954, respectively, and against William W. and Dixie C, Leerskov in the amount of $2,050.89 for the year 1954, be and the same is hereby modified in that the gross income is to be recomputed in accordance with the Opinion of the Board. in all other respects, the action of

Appeals of Aaron T. and Viola P. Felkins
William L. and Bertha M. Felkins
William W. and Dixie C. Leerskov

the Franchise Tax Board is sustained.

Done at Sacramento, California, this 18th day of July, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Riley, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: Dixwell L. pierce Secretary